FINANCIAL CRISIS ADVISORY GROUP

Baruch College Newman Conference Center
New York, NY

February 13, 2009

Agenda*

9:00–9:30am	Closed Session (for FCAG members and official observers) (part I)
	Public Advisory Meeting
9:30am-1:30pm	Opening Remarks (by co-chairs)
(15-minute break included)	Issues Discussion (led by co-chairs)**:

Session Objective: To obtain FCAG members' views on the following issues:

- At whom should general purpose financial statements be primarily aimed and why?
- Should general purpose financial statements have a financial stability objective? Why or why not?
- With specific reference to fair value, should financial stability or pro-cyclicality be considered even if a loss of transparency of information would result?
- For whole loans, should we (a) retain the current accounting model based on amortized cost and "incurred losses" but stress the permitted use of sound judgment in provisioning or (b) move to a different approach, for example, to fair value or to a method based on "dynamic provisioning"?
- What principles should determine when financial instruments are carried at fair value and when changes in fair value should be included in profit or loss (earnings)?
- What additional guidance, if any, is needed in the area of determining fair value?
- What are the best ways to bring about useful information regarding securitizations and other structured entities?

Discussion of Next Steps (led by co-chairs):

- Next meeting, issues to be discussed at that meeting, and additional information needed for that meeting
- Concluding Remarks by co-chairs

1:30 – 4:00 pm	Lunch and Closed Session (for FCAG members and official observers) (part II)

*Times are listed EST.
**Issues in this list that are not discussed at the current meeting, because of time constraints, will be discussed at the next meeting, on March 5th. Please also note that the issue of gains from fair value changes in an entity's own debt will be discussed at the March 5th meeting.

INTRODUCTION

This document contains a number of questions relating to the purpose of financial reporting. It identifies a number of specific areas for discussion, including the consideration of the need for providing information that is useful to investors in light of financial stability and pro-cyclicality concerns. It asks whether both of these objectives can be satisfied. It also contains questions about what information is useful to investors.

Questions 1 and 2 explore who financial statements should primarily be targeted at, and whether including a financial stability objective is consistent with that focus.

Questions 3 and 4 explore the trade-off between (a) sacrificing information that might be useful to investors so that they meet a financial stability objective and (b) possibilities for providing information that meet both objectives—assuming fair value information is useful to financial statement users. Question 3 explores the trade-off between not using fair value to meet a financial stability objective or to dampen pro-cyclicality. Question 4 explores the same issue in the context of provisioning.

Questions 5, 6, and 7 explore how the information users get today can be improved and simplified. Questions 5 and 6 address the trade-off between fair value (and some of the practical issues associated with fair value measurements) and cost-based measures. Question 7 focuses on off-balance-sheet activities.

This paper has been prepared solely for the purpose of facilitating discussion at the February 13, 2009, meeting of the Financial Crisis Advisory Group. The views contained herein do not represent official positions of the IASB or the FASB. Official positions of the IASB and the FASB are arrived at only after extensive due process and deliberations.

Question 1: At whom should general purpose financial statements be primarily aimed and why?

Both the FASB's and the IASB's existing conceptual frameworks indicate that the objective of general purpose financial statements of business entities is to provide information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. Such users include present and potential investors, lenders, suppliers and other trade creditors, customers, employees, governments and their agencies, and the public. Primacy is given to the informational needs of investors (both equity and debt security holders). Paragraph 10 of the IASB's *Framework for the Preparation and Presentation of Financial Statements* indicates the following:

> While all of the informational needs of [the various] users [listed above] cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

Primacy is **not** given to the needs of governments and their agencies or to lending financial institutions and credit rating agencies, for example, because those entities typically have the power to obtain additional financial information directly from management. Typically, most investors do not have this power.

In the first phase of their joint conceptual framework project, the two Boards have tentatively retained the investor focus for general purpose financial statements for the same reasons described above.

In calling for enhanced investor input to improve the FASB's standard-setting process, the Advisory Committee on Improvements to Financial Reporting to the U.S. Securities

and Exchange Commission (SEC) states the following in Recommendation 2.1 of their Final Report (August 2008):

> Investor perspectives are critical to effective standards-setting, as investors are the primary consumers of financial reports. Only when investor perspectives are properly considered by all parties does financial reporting meet the needs of those it is primarily intended to serve. Therefore investor perspectives should be given pre-eminence[15] by all parties involved in standards-setting.
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> [15]We recognize the need for balance among all parties involved in the standards-setting process. We do not intend to suggest by this recommendation that investor input trumps all others. Instead, in cases where constituent views cannot be reconciled, we believe that the investor perspective should be afforded greater weight.

Do you agree with this investor-centered view or do you believe that general purpose financial statements should primarily be aimed at other financial statement users? If so, which users?

Question 2: Should general purpose financial statements have a financial stability objective? Why or why not?

Both the FASB's and the IASB's existing conceptual frameworks, as well as the proposed revised framework, aim for transparency in general purpose financial statements to push information to investors and other users so they make informed capital resource allocation decisions. The frameworks stress the importance of having the information in general purpose financial statements be **neutral**, that is, free from bias. Paragraph 36 of the IASB's *Framework* indicates the following:

> To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Under both Boards' frameworks, financial reporting would **not** be aimed at steering investors to make decisions that are consistent with such macroeconomic policy objectives as financial stability. Stephen Haddrill's comments in his submission for the current meeting exemplify this view:

> It is our strong belief that financial reporting should be designed for the benefit of investors….Financial stability is a responsibility of regulators, not of investors. Regulators' objectives, being largely concerned with solvency and with pro-cyclicality, are different from investors', who seek to maximize their return, and their respective information needs are not the same.

An alternative view stresses that financial reporting is an integral part of a functioning marketplace and, thus, falls within the purview of fiscal policy goals of ensuring financial stability at a macroeconomic level. While the Group of 30 (G-30) does not explicitly state this in its report, *Financial Reform: A Framework for Financial Stability*, recommendation 12, item c, implies such an underlying view:

> Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit

> loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios.

Some proponents of a financial stability objective also have made arguments along the lines of the following: “Accounting is an inexact science anyway; it is full of estimates, so the least we should expect from it is that it does no macroeconomic harm.”

Which of these two general views is closer to your own view, and why?

Question 3: With specific reference to fair value, should financial stability or pro-cyclicality be considered even if a loss of transparency of information would result?

Question 5 addresses the usefulness of fair values for financial instruments. For purposes of this question, assume that the fair value information required currently in financial statements provides information that is useful to investors.

Some say that financial reporting should reflect the underlying economics, good or bad, of an entity's business and that fair value is the measurement basis that best reflects those economics, encompassing all of the expectations and environmental factors affecting the value of the entity's resources and obligations. Those proponents would say that fair value accounting is by nature somewhat pro-cyclical and that we should not try to dampen that pro-cyclicality by altering the data in the name of financial stability. Moreover, they would argue that **not** providing information that best reflects the underlying economics leaves investors at a disadvantage, potentially leading to far more harmful pro-cyclical effects when the early warning signs that may have been seen with "raw" information are latent until actual cash losses are incurred much later. There is a "cliff effect" resulting from the loss of investor confidence in such circumstances.

Others say that financial reporting shouldn't merely reflect markets with all of their "irrational exuberance" or "primordial fear." Instead, financial reporting should help shape markets with the goal of maintaining financial stability. Proponents of this view would seek to dampen pro-cyclicality by using measurement bases other than fair value, or by significantly changing the way in which fair value is determined so that it is effectively no longer fair value. By bypassing or ignoring all of the short-term "noise" that would emanate from "raw" fair value measures, they believe they can keep markets as stable as possible and help shield the markets, their participants, the financial system,

and the economy from wild swings. As noted in the discussion of question 2, some who hold this view also fall back on the do-no-harm-with-imprecise-measurements argument.

Should the use of fair values for financial instruments be omitted, altered, or suppressed when they provide useful information to investors to promote financial stability or reduce pro-cyclicality? Is it possible to provide financial statement information that is useful to investors yet still meets financial stability and pro-cyclicality objectives?

Question 4: For whole loans, should we (a) retain the current accounting model based on amortized cost and "incurred losses," but stress the permitted use of sound judgment in provisioning or (b) move to a different approach, for example, fair value or a method based on "dynamic provisioning"?

The two parts of question 4 relate to the short-and long-term recommendations expected to come out of the Financial Stability Forum's Working Group on Provisioning. The short-term recommendation would remind financial institutions that, even in provisioning under the existing accounting model, they should diligently incorporate appropriate consideration of changes in environmental and economic factors. The long-term recommendation would call on the IASB and the FASB to reconsider loan loss provisioning requirements as expeditiously as possible, while in the process also considering the merits of more through-the-cycle approaches.

Consistent with the IASB's and the FASB's conceptual frameworks, any such reconsideration would start with the question of what information would be useful to financial statement users, especially investors. There are a number of considerations for each of the possible approaches.

Under the incurred loss model, there are issues that have been identified relating to the recognition of impairment. There are different loan loss recognition criteria and different loan loss measurements based on how an instrument is classified, that is, as available (held) for sale or held for investment. There also are differences in these regards between International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (GAAP). Under U.S. GAAP, the impairment approach for held for investment loans is inconsistent with that of held to maturity debt securities, which also are carried at amortized cost.

A fair value alternative for loans would eliminate the deficiencies of recognizing impairment on an incurred loss basis. A fair value alternative for financial instruments, including loans, is discussed under question 5. Even a revised mixed measurement approach, also discussed under question 5, could reduce some of the complexity; for example, by specifying a single impairment model for loans and other financial instruments carried at amortized cost.

As we noticed from some participants' comments at the January 20 meeting, any consideration of dynamic provisioning in the context of financial reporting would need to begin with a better common understanding of what that approach does and does not entail. One of those participants, John Smith of the IASB, has provided the following list of questions that he feels should be answered before standard setters evaluate the appropriateness of dynamic provisioning as a method for financial reporting purposes and regulatory capital purposes:

- The thought of having a buffer clearly is appealing in today's environment. However, can we really talk about dynamic provisioning when we don't know what it is, and whether it is an accounting issue or a regulatory capital issue?
- If this is a regulatory capital issue, regulators would need to decide how to determine the provisions and when to apply the provisioning scheme. Accounting standard setters could support the regulatory initiative by requiring the allocation of an entity's capital in the equity section to identify the portion being set aside for regulatory purposes.
- If this is an accounting issue, it would be necessary to determine whether this approach is simply a clarification or a better measurement of the incurred loss model that currently exists or an expansion to require recognition of additional or excess losses in the good times so there will be a buffer to fall back on in bad times.
- For accounting purposes, how would a dynamic provision be measured?
    - Could an asset be written down below its fair value under a dynamic provisioning methodology?
    - Would the provision be based on individual assets, certain specified assets, or all financial assets of an entity?
    - Alternatively, would it be determined on a bank-by-bank basis depending on a bank's net income, capital, or some other metric?

- Would it be applied on a bank-by-bank basis depending on which banks are doing good or bad, or on a regional/country basis, or to all banks around the world?
- When would it be applied and when should it start? While many wish there were buffers now, there seems to be universal agreement that now is not the time to start.
    - Who would decide when to start using dynamic provisioning? Would it be started at the entity level, at a regional or country level, or at the discretion of the regulator?
    - If this is an accounting issue, what criteria should be in the proposed standard to start the provisioning and what criteria should be used to reduce provisions previously recognized?
- How would the proposed standard provide for comparability and ensure that an entity, a region, or country is not disadvantaged if (a) the entity, region, or country started to improve ahead of other countries and was required to provide additional reserves or (a) another entity started to reverse or use up provisions previously established because it was experiencing an unfavorable downturn?

It is our hope that, through a combination of the background materials provided by members of the Basel Committee for the current meeting and the discussion at the meeting, we can take positive steps toward that common understanding.

Finally, in his submission for the current meeting, Yezdi Malegam alludes to other possible through-the-cycle approaches to loan provisioning:

> - The present approach to loan provisioning is to make provisions on an "incurred loss" basis, even though, financial institutions, when pricing products recognize the specific risks attached to individual products and individual borrowers.
> - Is there therefore a need to make continuous provisions during the lifetime of the loan in the same way as a manufacturer builds up provisions for possible future warranty claims as required under the standards?
> - This is different from "dynamic" provisioning which is often based on the availability of profits in good years. Rather, it is the recognition of the "latest risk" which exists in respect of standard assets and provision is made for this risk on a scientific basis taking into account past experience and changes in the macroeconomic environment.

Which of these approaches do you believe would provide the most useful information to investors? Is it possible to develop a method for recognizing loan loss impairment that would meet both investor needs and financial stability and pro-cyclicality objectives? Should a dynamic provisioning approach be used for capital purposes, with disclosure for accounting purposes to set aside capital in good times to provide a capital buffer in bad times?

Question 5: What principles should determine when financial instruments are carried at fair value and when changes in fair value should be included in profit or loss (earnings)?

As summarized in the charts included in the advance materials for the first meeting, and in Professor Stephen Ryan's paper, "Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch," the current U.S. GAAP model is a mixed attribute (mixed measurement) model that depends somewhat on an entity's business model, that is, on management's intent. For most industries, some financial assets are carried at fair value with all changes included in profit or loss. Other financial assets are carried at fair value with only certain changes, including other-than-temporary impairments, included in profit or loss. And, still other financial assets are carried at amortized cost, with only changes in fair value deemed other-than-temporary impairments included in profit or loss. Most financial liabilities are carried at amortized cost rather than fair value, unless they are derivative instruments or guarantees or the entity has elected the fair value option for that liability. The 10-year old IFRS model was derived from U.S. standards and is substantially the same.

There is widespread agreement, even among both Boards, that the current IASB and FASB models are suboptimal. They are overly complex, diminish comparability, and make financial statements difficult to understand. The models arguably put too much tension on highly judgmental areas such as the other-than-temporary impairment assessment.

Many believe that fair value accounting for financial instruments will resolve these difficulties. For example, Professor Ryan's paper makes the case for why fair value, "warts and all," is probably the best measurement basis for all financial instruments and why reporting all fair value changes in profit or loss helps ensure that that measure best

reflects the underlying economic reality. As an important side benefit for both Boards and their constituents, going this route would automatically eliminate the need to continue to grapple with the difficulties of defining and distinguishing instances of other-than-temporary impairment.

However, not all investors—nor, for that matter, all academics—would support full fair value for all financial instruments. For example, many investors are concerned with the counterintuitive result of recognizing a gain on a decline in the fair value of an entity's debt. Many investors also question the use of fair values that give rise to Day 1 profits when they are based on information that is not observable in the marketplace. Preparers, auditors, and regulators generally share these concerns.

Conversely, while regulators are concerned about the use of fair values when markets are illiquid, they support using fair values for all derivatives even when markets are illiquid.

While some of the concerns may ultimately be a matter of working out the "kinks" of fair value measurement (see question 6), others may reflect a more fundamental disagreement about the appropriateness of using fair value in certain instances. Those with such disagreements would opt to retain a mixed measurement model, but make refinements to it. The G-30 report, for example, seems to suggest going down this route.

Should we use fair value for all financial instruments, with all changes therein included in profit or loss, or should we continue to have a mixed measurement system? If we retain mixed measurements, what basis should be used to determine which instruments are at fair value? For example, should the distinction be based on how management runs the business or should it be based on the risk related to the financial instrument? For example, would investors benefit from a mixed measurement approach that requires fair value for risky financial instruments (for example, derivatives and subordinated securitization investments) and permits amortized cost for plain vanilla loans,

receivables, and debt instruments, while allowing management discretion for using fair values based on its business model only for the more stable, plain vanilla instruments?

Please note that the issue of gains from fair value changes in an entity's own debt will be discussed at the March 5th meeting.

Question 6: What additional guidance, if any, is needed in the area of determining fair value?

FASB Statement No. 157, *Fair Value Measurements*, defines fair value as follows:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

In its fair value measurement guidance project, the IASB is considering the appropriateness of the guidance in Statement 157, but is currently expected to issue final guidance that will contain a largely similar current exit price approach to fair value.

While there are many different views concerning the appropriateness of fair value for various types of financial instruments under various scenarios, a number of constituents have expressed a desire for (a) additional application guidance for identifying illiquid or inactive markets and for determining the impact of liquidity on fair value and (b) additional disclosures on how entities have determined fair value in such circumstances. Recommendations in this area come from such otherwise divergently-viewed constituents as Professor Stephen Ryan, the G-30, and the SEC, in their respective papers/reports.

The IASB recently issued guidance developed by an expert panel that identified issues relating to the difficulties of measuring fair value when markets are illiquid. The guidance focused on the information that can be used when markets are illiquid and emphasized the judgment needed to arrive at the fair value estimate. It also identified disclosure practices that would provide greater transparency about the use of fair value estimates in financial statements. Other efforts in this area by the IASB and the FASB were described by Gavin Francis and Russ Golden at the January 20 meeting.

Another area for which additional guidance has been sought by constituents is contractual restrictions on transfer of liabilities. Most indebtedness can only be settled, not transferred to third parties. The FASB is currently addressing this matter with proposed FASB Staff Position (FSP) FAS 157-c, *Measuring Liabilities under FASB Statement No. 157*, which is being redeliberated and is expected to be issued in March 2009.

The SEC's *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* also calls for additional consideration by the FASB of a number of other fair value implementation matters. The FASB is currently vetting these matters with its Valuation Resource Group.

Some believe that additional guidance is needed. Others are concerned that more guidance will lead to rules and limit the use of judgment. What additional guidance, if any, do you believe is needed in the area of determining fair value, and why? Do you believe that providing more guidance will limit the use of judgment?

Question 7: What are the best ways to bring about useful information regarding securitizations and other structured entities?

This initial question on securitizations and other structured entities focuses primarily on informational display issues. At the next meeting, we will continue our discussion with a more in-depth consideration of the issues surrounding derecognition of transferred assets.

Securitization is the process by which financial assets are transformed into securities. Under current accounting literature, many securitizations are accounted for as sales with recognition of the related gain or loss and the assets being removed from the balance sheet. If an entity transfers financial assets, surrenders control of those assets to a successor entity, and has no continuing involvement with those assets, accounting for the transaction as a sale and derecognizing the assets and recognizing the related gain or loss is not controversial. However, accounting for transfers of financial assets has been controversial and inconsistent in circumstances in which an entity transfers only a partial interest in a financial asset or has some other continuing involvement with the transferred asset or the transferee. In many securitization transactions, the transferring entity retains substantial risks and benefits related to the assets being transferred.

An entity that transfers the assets that are securitized has many motivations for performing this, including lower capital requirements if transfers are accounted for as sales, risk transference (including credit, liquidity, and prepayment risk), lower funding costs, liquidity, and realization of profit with the associated sale. Other structured non-consolidated entities are designed by an entity to effect a specific transaction or transactions. Generally, the motivation for creating these entities is similar to those identified for securitizations above.

There are three primary ways that have been identified to provide useful information for users of financial statements, including:

Consolidation and Derecognition—Many people believe that more information about securitizations and other structured entities should be on the consolidated balance sheet of the sponsoring entity. All of the related assets and liabilities would be recognized on the face of the balance sheet with all other assets and liabilities of the consolidated entity, either commingled or displayed separately. Many people believe that derecognition of financial assets should not be permitted if the entity that is transferring the asset has any continuing involvement in the assets in the form of risk retention. Others, however, believe that financial assets should be divided into components, and that the component being transferred be derecognized even if the entity retains risk related to that component.

Linked Presentation—The principle behind linked presentation is to present on the face of the balance sheet the linkage between certain assets and liabilities of an entity that result from consolidation of a specific entity or group of entities. In particular, when the consolidated assets of the specific entity or group of entities are segregated or pledged for the repayment of the specific consolidated liabilities of the aforementioned entity or groups of entities (and those assets are not available for the benefit of general creditors and investors of the consolidated entity), it is important to clearly identify these assets and liabilities on the face of the balance sheet as being linked. Proponents of this approach believe that presenting assets and liabilities as linked on the face of the balance sheet provides financial statement users clear information regarding the assets recognized by the consolidated entity, which are designed for repayment of specific liabilities. There are, however, a number of scope and implementation issues that would need to be resolved before mandating such an approach.

Disclosure—The third method involves enhancing current disclosure to provide additional information to financial statement users. For example, the principles of the additional disclosures related to securitizations and other structured entities would be to provide more detail on the following:

- The entity's involvement with the securitizations and other structured entities

- The nature of, and changes in, the risks associated with the entity's involvement with the securitization and/or other structured entity
- The nature of how the entity's involvement affects the entity's financial position, financial performance, and cash flows.

Which of these three methods would provide the most useful information in a cost-beneficial manner and why? Are there any other methods that you would suggest?